

Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **200901031**

Release Date: 1/2/2009

CC:CORP:B04:
POSTF-132975-05

UILC: 1502.21-00

date: June 15, 2006

to:

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subject: Application of Lonely Parent Rule Following 82-152 Transaction

General Statement of the Government's Position

The Service acknowledges that the SRLY rules and the Lonely Parent exception to the SRLY rules apply to both carrybacks and carryforwards of NOLs. Further, the Service acknowledges that the Lonely Parent rule applies following a 82-152 transaction. However, the Service's position is that there is no amendment to the general application of the Lonely Parent rule for carrybacks to years following 82-152 transactions (post-restructuring years). Thus, the general Lonely Parent rule applies to grant non-SRLY status to separate return years of the member who was the common parent of the group in the year to which the loss is carried (the Actual Common Parent), and the SRLY limitation applies to the Historic Group's use of the loss carryback attributable to the member that was the common parent prior to the 82-152 transaction (Former Common Parent).

The Parties' Arguments

The taxpayer acknowledges that Former Common Parent was not the common parent of the Historic group in the carryback year, and further that Former Common Parent does not qualify for the reversal of the Lonely Parent exception found at §1.1502-1(f)(3). See Taxpayer's submission at 12, n.14. However, the Taxpayer argues that Former Common Parent is entitled to application of the 75(d)(2)(ii) exception to the Lonely Parent rule with regard to its carrybacks to post-restructuring

years of the Historic group because of the similarity of the 82-152 transaction to a 75(d)(2)(ii) transaction. The Taxpayer asserts that such application of the 75(d)(2)(ii) will result in Lonely Parent status shifting from the Actual Common Parent to the Former Common Parent with regard to the carryback at issue. The Taxpayer appears to rest its argument for its requested exception to the Lonely Parent rule on major points: (1) A tax policy analysis, and (2) a “basic requirement” of consistency with regard to carryforwards and carrybacks.

The Service responds that extension of the 75(d)(2)(ii) exception to the Lonely Parent rule to 82-152 transactions provides no relief to the Taxpayer because the resulting exemption from SRLY treatment for the separate return years of the former common parent (even with regard to actual 75(d)(2)(ii) transactions) applies only with regard to loss carryforwards to the post-restructuring group. In fact, nothing in the regulations provides a reversal of the Lonely Parent rule for carrybacks under any circumstances. Further, application of the Taxpayer’s theory leads to clearly unacceptable and even nonsensical results. First, under certain circumstances, the government would be put in the position of extending Lonely Parent status to two different entities simultaneously – the former common parent, as well as the actual Common Parent of the group in the carryback year. Second, full acceptance of the Taxpayer’s theory would mean that, in any case in which the historic group continues for an extended period of time following the Former Common Parent’s disaffiliation, the group is effectively denied any benefit of the Lonely Parent rule for carrybacks.

The Lonely Parent Rule and Its Exceptions

The Lonely Parent Rule in General

Under the SRLY rules, losses imported into a consolidated group from separate return years are subject to SRLY limitations. See §1.1502-1(f)(1) and -21(c). The Lonely Parent exception to the SRLY rules excepts from SRLY status a “separate return year of the corporation which is the common parent for the consolidated return year to which the tax attribute is to be carried (except as provided in §1.1502-75(d)(2)(ii) and [§1.1502-1(f)(3)]).”¹ §1.1502-1(f)(2)(i). Because the Former Common Parent was not the actual common parent in the year to which the loss is being carried, the general operation of the Lonely Parent Rule (without an exception for 82-152 transactions) does not provide relief from the application of the SRLY limitation to use of Former Common Parent’s losses by the Historic group in the year at issue.

As discussed further below, the stated exceptions to the Lonely Parent rule (provided in §1.1502-75(d)(2)(ii) and -1(f)(3)) amend the Lonely Parent Rule with regard

¹ The Lonely Parent exception to the SRLY rules effectively treats the common parent as “the embodiment of the group”, and its application generally ensures that the common parent’s importation of losses into the group is not tainted by SRLY limitation. See Dubroff, et al., Taxation of Corporations Filing Consolidated Returns §42.02[2], n.163.

to carryforwards only. In those cases, the actual common parent of the group loses its Lonely Parent status for carryforwards to post-restructuring years, and this Lonely Parent status is granted to the former common parent of the group.² However, in neither case does the regulation amend Lonely Parent status with regard to carrybacks. Therefore, the general Lonely Parent rule applies to carrybacks, resulting in the retention of Lonely Parent status by the actual common parent of the group for the year to which the loss is carried back.

The Lonely Parent Exception for 75(d)(2)(ii) Transactions

As discussed above, the Lonely Parent Rule generally provides that separate return years of the corporation that is common parent of the group in the year to which a loss is carried will be exempted from SRLY treatment. §1.1502-1(f)(2)(i). This general rule is altered in the case of 75(d)(2)(ii) Transactions. The taxpayer argues that this alteration should also following 82-152 transactions, and that if it does so apply, the Former Common Parent's carrybacks to post-restructuring years of the Historic group will not be subject to SRLY limitation. The government responds that the alteration of the Lonely Parent rule in the case of 75(d)(2)(ii) transactions applies only for purposes of carryforwards to post-restructuring years, and thus application of the 75(d)(2)(ii) exception to 82-152 transactions provides no relief from SRLY limitation to the Former Common Parent's carryback to post-restructuring years.

In a typical 75(d)(2)(ii) transaction, the common parent of the group merges downstream into another group member. Section 1.1502-75(d)(2)(ii) provides that the group will not terminate

notwithstanding that the common parent is no longer in existence if the members of the affiliated group succeed to and become the owners of substantially all of the assets of such former parent and there remains one or more chains of includible corporations connected through stock ownership with a common parent corporation * * *".

Thus, in 75(d)(2)(ii) transactions, the historic common parent ceases to exist, and another member of the group becomes the new common parent.

With regard to the application of the Lonely Parent Rule following a 75(d)(2)(ii) Transaction, the regulation provides:

For purposes of applying paragraph (f)(2)(i) of § 1.1502-1 [the Lonely Parent Rule] to separate return years ending on or before the date on which the former parent ceases to exist, such former parent, and not the new common parent, shall be considered to be the corporation described in such paragraph.

² In each case, the former group does not terminate. Instead, the group continues, but with a new common parent.

By definition, every 75(d)(2)(ii) transaction involves a situation in which the former common parent ceases to exist. Thus, the regulation on its face can apply the reversal of the Lonely Parent Rule to carryforwards only – separate return years ending on or before the date on which the former parent ceases to exist, which is the date of the restructuring transaction. By application of the reversal of the Lonely Parent Rule to 75(d)(2)(ii) transactions, the former common parent receives the benefit of the Lonely Parent Rule for purposes of carrying losses forward from separate return years to the post-restructuring years, even though it is not the actual common parent for those years. Because there is no such amendment to the Lonely Parent rule with regard to carrybacks, the actual common parent continues to enjoy the benefit of the general application of the Lonely Parent Rule for purposes of carrying losses back from separate return years to such post-restructuring years.³

Because the reversal of the application of the Lonely Parent Rule in the case of 75(d)(2)(ii) Transactions applies only to carryforwards by the former common parent, not to carrybacks, application of the 75(d)(2)(ii) exception to the Lonely Parent Rule in the case of 82-152 transactions provides no relief from SRLY status to the Former Common Parent's carryback.

The Lonely Parent Exception for Reverse Acquisitions

A reverse acquisition is essentially a “minnow swallowing a whale” case, in which a smaller corporation in form acquires a larger one. Where this occurs, and where the shareholders of the larger corporation, by virtue of having been shareholders of such larger corporation, hold more than half of the stock of the post-acquisition, combined entity, §1.1502-75(d)(3) applies. If §1.1502-75(d)(3) applies, any group of which the larger corporation was the common parent will continue, but with the smaller corporation as its new common parent. §1.1502-75(d)(3)(i). In the case of a reverse acquisition, §1.1502-1(f)(3) provides that the operation of the Lonely Parent exception to the SRLY rules is amended as follows:

All taxable years of the first corporation [i.e., the smaller corporation, who will be the new common parent] and of each of its subsidiaries ending on or before the date of the acquisition shall be treated as separate return limitation years, and the separate return years (if any) of the second corporation [i.e., the larger corporation, who is the former common parent] and each of its subsidiaries shall not be treated as separate return limitation years (unless they were so treated immediately before the acquisition).

³ The Taxpayer notes that the Service has issued rulings that extend the 75(d)(2)(ii) exception to the Lonely Parent rule to carryforwards to years following 82-152 transactions. Such treatment is entirely consistent with the application of the continuation of the group conclusion of Rev. Rul. 82-152, and the fact that the 75(d)(2)(ii) exception to the Lonely Parent rule (as well as the Reverse Acquisition exception to the Lonely Parent rule) applies to carryforwards, though not to carrybacks.

Thus, in recognition of the continuation of the historic group of which the second corporation had been common parent, the Lonely Parent Rule is reversed, as quoted above, to provide that carryforwards by the new common parent – the first corporation – to post-restructuring years will be treated as SRLY. Thus, the new common parent loses its Lonely Parent status for carryforwards, and the former common parent – the second corporation – is granted the benefit of the Lonely Parent Rule with regard to carryforwards.

However, there is no reversal in the regulations with regard to carrybacks by the new common parent to such post-restructuring years. Therefore, the new common parent maintains the benefit of the general Lonely Parent exception with regard to carrybacks, even though the former common parent has been granted the benefit of the Lonely Parent Rule with regard to carryforwards. See CCA 200441026. It is notable that the new, actual common parent takes Lonely Parent status for carrybacks even though (as in the case of an 82-152 transaction) the former common parent continues to exist and remains within the group. This reading of the regulation has been adopted by leading commentators in the field.⁴

The Taxpayer's Arguments

The Taxpayer argues that Former Common Parent is entitled to Lonely Parent status with regard to its carrybacks to years of the Historic group following the 82-152 transaction (post-restructuring years) because of the similarity of the 82-152 transaction to a 75(d)(2)(ii) transaction. The Taxpayer makes this argument despite the fact that there is no possibility of a carryback by a former common parent to post-restructuring years in the case of an actual 75(d)(2)(ii) transaction, because in a 75(d)(2)(ii) transaction the former common parent goes out of existence. Thus, the Taxpayer argues not only for the extension of the 75(d)(ii) exception to 82-152 transactions, but for the creation of a new exception that goes beyond what is contemplated by the 75(d)(2)(ii) exception.⁵ The Taxpayer supports its argument for this additional exception

⁴ The lonely-parent rule applies to carryforwards and carrybacks. Thus, when a corporation filing a separate return sustains a loss, it may carry the loss back without limitation to a year in which it was the common parent of a consolidated group. However, if the loss corporation was not the common parent during the carryback year because of a reverse acquisition, the lonely-parent rule would only apply to the common parent in form.

Hennessey, et al., The Consolidated Tax Return, at §8.05[2], n.52 (citing CCA 200441026). See also id. §4.01[2], n.16.1 (citing CCA 200441026 for the result described above); Dubroff, et al., Taxation of Corporations Filing Consolidated Returns, §42.02[2], n.163 (same), and §41.04, n.324 (same).

⁵ The Taxpayer argues that its position is supported by the facial application of the 75(d)(2)(ii) exception because that exception grants Lonely Parent status “to separate return years [of the former common parent] ending on or before the date on which the former parent ceases to exist * * *”, and the Former Common Parent has not ceased to exist. However, it is clear from the requirements necessary to the

to the Lonely Parent rule following 82-152 transactions with 2 basic points: (1) a tax policy analysis, and (2) a “basic requirement” of consistency with regard to carryforwards and carrybacks. Finally, the Taxpayer argues that, because Treasury and the Service have not specially addressed the treatment of 82-152 transactions, the Taxpayer is entitled to reasonably apply whatever guidance is available.

Policy Concerns

The Taxpayer argues that the policies underlying the application of the Lonely Parent Rule after a -75(d)(2) Transaction apply equally following an 82-152 Transaction. The Taxpayer further appears to assert that, if the drafters had considered the application of the Lonely Parent exception to the SRLY rules following an 82-152 transaction, the drafters would have dictated the result for which the Taxpayer argues. The Taxpayer’s argument amounts to sheer speculation, and the fact remains that the regulations do not contain a reversal of the Lonely Parent Rules with regard to carrybacks in the case of 82-152 Transactions (or any other transactions). See Arkansas Best Corp. v. Comm., 485 U.S. 212, 220 (1988) (exceptions from the normal taxing requirements must be narrowly applied).

Further, application of the Taxpayer’s theory leads to clearly unacceptable and even nonsensical results. Under certain circumstances, the government would be put in the position of extending Lonely Parent status to two different entities simultaneously – the former common parent, as well as the actual common parent of the group in the carryback year. This is a situation that the Taxpayer admits would be unacceptable. Second, to the extent that the Taxpayer’s theory is fully implemented, in any case in which the historic group continues for an extended period of time following the Former Common Parent’s disaffiliation, the group is effectively denied any benefit of the Lonely Parent rule for carrybacks to post-restructuring years.

Double Lonely Parent

The Taxpayer has argued that, under its interpretation of the regulations, there are not two Lonely Parents with regard to carrybacks to the year. It argues that the Former Common Parent is the Lonely Parent for both carryforward and carryback purposes, and that the Actual Common Parent for the years to which the loss is carried loses its status as Lonely Parent. See Taxpayer’s Submission at 26.

Taxpayer has cited and there exists no regulatory authority for withholding Lonely Parent status from the actual Common Parent with regard to carrybacks from its later

achievement of 75(d)(2)(ii) status that the drafters were not contemplating transactions in which a former common parent would continue in existence. Thus, they could not have been contemplating a case in which the Former common parent would generate losses that could be carried back. The application of the Lonely Parent in the case of Reverse Acquisitions further supports the government’s analysis, as does the clearly unacceptable results caused by full application of the Taxpayer’s theory, as described below.

separate return years. As discussed above, the regulations reverse the application of the Lonely Parent Rule only with regard to carryforwards in cases of 75(d)(2) Transactions and reverse acquisitions. There is no explicit reversal of the Lonely Parent rule in the regulations with regard to carryforwards or carryback in cases of 82-152 transactions. Under the principles of Woods Investment Co. v. Commissioner, 85 T.C. 274, 279-282 (1985), taxpayers are entitled to hold the Service to the precise language of its consolidated return regulations, even if policy or equitable considerations might militate toward a result different than that provided for in the regulations. Thus, if the Taxpayer's argument were correct, the Service would be put in the position of granting LP status with regard to carrybacks from the separate return years of both a former common parent and an actual common parent with regard to post-restructuring years.

Assume, for example, that the Historic Group terminated sometime after the 82-152 transaction, but in a year before Former Common Parent incurred the loss here at issue. Further assume that, following the termination of the group, the Actual Common Parent for the carryback year incurred a loss in an equivalent separate return that it wished to carryback to the Historic Group. Under the taxpayer's reasoning with regard to the former common parent, and the requirements of Woods Investment, both entities would then be in a position to claim Lonely Parent status.

The Taxpayers may argue that the preceding example is irrelevant to this case, as the Actual Common Parent has remained with the Historic Group and thus has no separate return years for which to claim Lonely Parent status. However, nothing in the Lonely Parent Rule distinguishes between carryback cases following a termination of the group vs. those for periods during which the group continues. Therefore, the technical application of the regulations must be consistent to both.

Complete Loss of Lonely Parent Exception for Carrybacks

As noted above, the Taxpayer argues that, following an 82-152 Transaction, the former common parent is granted Lonely Parent status for both carryforwards and carrybacks, and the actual common parent loses Lonely Parent status for both purposes. If the Taxpayer's theory were correct, and the actual common parent could indeed be denied Lonely Parent treatment for carrybacks, in any case in which the historic group continues for an extended period of time following the disaffiliation of its former common parent, the group is effectively denied any benefit of the Lonely Parent rule for purposes of carrybacks.

Consider the following example:

Assume that a group is formed in Y1. An 82-152 transaction occurs in Y5, and the former common parent remains in the group until the end of Y7. Former common parent incurs losses that are only entitled to 2-year carryback treatment. The group terminates at the end of Y10, and the corporation that is the actual

common parent in the post-restructuring years incurs a separate return loss in Y11. Under the Taxpayer's theory, because the former common parent (and not the actual common parent) is entitled to Lonely Parent treatment for carrybacks to post-restructuring years, the group is denied any benefit of the Lonely Parent rule for carrybacks to those years.

The regulations do not contemplate that any group will be foreclosed from any possibility of claiming the benefit of the Lonely Parent rule. But the Taxpayer's theory divorces the identity of the Lonely Parent for the year to which the loss is being carried from the actual identity of the group members in that year. Thus, under the Taxpayer's theory, the entity that is entitled to Lonely Parent treatment could be a corporation that had not been a member of the group for 10, 20, 30 or more years. Thus, it would be impossible for such corporation to carry anything back to such group (whether under SRLY taint or not). Because application of the Taxpayer's theory would lead to such an absurd result, it should be rejected. See, e.g., Exxon Corp. v. Commissioner, 102 T.C. 721, 728-729 (1994), *affd.* by Texaco v. Commissioner, 98 F.3d 825 (5th Cir. 1996).⁶

Consistency

The Taxpayer further asserts that the Lonely Parent Rule does not distinguish between carryforwards and carrybacks, and for this reason, there is a "basic requirement" that the same corporation must be the Lonely Parent for purposes of carrying losses forward and back to a given consolidated return year. The Taxpayer's assertion is unsupported by the law. As discussed above, the Lonely Parent Rule, through its exceptions/reversals made in the case of 75(d)(2)(ii) Transactions and Reverse Acquisitions, does indeed distinguish between carryforwards and carrybacks. In both cases, the former common parent is the Lonely Parent for purposes of carryforwards to post-restructuring years, whereas the actual common parent for those years has Lonely Parent status for purposes of carrybacks to those same post-restructuring years. In fact, there is no instance in which the regulations ever grant Lonely Parent status with regard to carrybacks to any entity other than the actual common parent.

Gottesman Argument

Last, the Taxpayer argues that, because Treasury and the Service have not specially addressed the treatment of 82-152 transactions, the Taxpayer has been left with no guidance on the treatment of these transactions, and it is therefore entitled to reasonably apply whatever guidance is available. The Taxpayer argues that its reversal

⁶ The Taxpayer may argue that, in such a case, a nonsensical result can be avoided by transferring Lonely Parent status back to the actual common parent for the year to which the loss is carried. However, the fact that such a solution requires creation of even more rules not contemplated by the regulation further supports the government's position that the Taxpayer's desired result is not supported by the regulations as written.

of the application of the Lonely Parent Rule is reasonable. See Taxpayer's Submission at 28-29.

The Taxpayer cites Gottesman v. Commissioner, 77 T.C. 1149, 1157-1158 (1981) in support of its "reasonable application" argument. Taxpayer's analogy to Gottesman is without merit. Gottesman involved the question of the proper method of calculating the accumulated earnings tax for members of a consolidated group where there was no guidance whatsoever regarding methodology in the consolidated return regulations.

The Taxpayer points out that a guidance project was previously opened with regard to continuation of the group issues, and it notes that no guidance was ultimately produced. Although the Taxpayer infers from the existence of the project that there is an ambiguity in the regulation with regard to the issue at hand, this is simply the Taxpayer's inference. The fact is that Treasury and the Service decided that no changes should be made to the regulations at that time. Thus, the current regs stand.

As discussed above, because there is no exception reversing application of the Lonely Parent Rule to carrybacks to post-restructuring years, the general Lonely Parent Rule applies. Therefore, the SRLY rules impose a limitation on the group's use of the carryover at issue, as the Lonely Parent rule provides an exception from SRLY treatment to the Actual Common Parent, but not to the Former Common Parent. This is not a case in which the regulations fail to provide guidance. The taxpayer is simply unhappy with the outcome produced by the rule that does exist and argues for the creation of an exception. Therefore, unlike in Gottesman, there is law on point which must be applied, and which cannot be overridden by "reasonable application" arguments.

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